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### Subchapter S of the 1954 Code

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## SUBCHAPTER S OF THE 1954 CODE

Section 1361 of the Internal Revenue Code of 1954 gives unincorporated business enterprises which meet the qualifications of section 1361(b) the opportunity to elect taxation as a domestic corporation. This election, however, has been sparsely used, apparently being most favorable to a non-corporate business with sudden large profits toward the end of its taxable year,<sup>1</sup> and to business owners who fall within a high income bracket<sup>2</sup> and cannot incorporate.<sup>3</sup> Now, by the Technical Amendments Act of 1958 ("Mills Bill"),<sup>4</sup> an entirely new subchapter,<sup>5</sup> which gravely affects the choice of business form, has been added to the Code. This subchapter provides an election for small business corporations which will eliminate the tax at the corporate level and hence result in the imposition of a single tax on the shareholder at his individual rate, thereby apparently equating him with a partner<sup>6</sup> or proprietor engaged in a similar business with the same capacity for income. This uniformity of tax treatment for businesses which are essentially similar except for the form of business organization is the object of the new legislation. Its provisions represent an attempt to "permit businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence."<sup>7</sup> The mechanics necessary to the fulfillment of this purpose are found in new Code sections 1371 through 1377.<sup>8</sup> Whether these sections will properly serve to carry out the legislative intent of the enacting Congress is a question now precariously open to all Saturday morning quarterbacks.

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<sup>1</sup> See SURREY & WARREN, *FEDERAL INCOME TAXATION* 1237 (1955 ed.). Section 1361(a) of the Internal Revenue Code of 1954 allows an election to be made within sixty days after the close of the taxable year. All sections hereinafter referred to are sections of the Internal Revenue Code of 1954, unless expressly stated otherwise.

<sup>2</sup> See McNaughton, *To Be Taxed as a Corporation*, 33 *TAXES* 253, 257 (1955). For a discussion of the desirability of an election under § 1361 in various situations, based on a comparison of business and outside income, see Moore, *Should Your Business Be Taxed as a Corporation?*, 33 *TAXES* 258 (1955).

<sup>3</sup> In New York, for example, lawyers are not permitted to incorporate. N.Y. STOCK CORP. LAW § 7.

<sup>4</sup> 72 STAT. 1606 (1958).

<sup>5</sup> Subchapter S of Chapter I of Subtitle A of the 1954 Code is entitled "Election of Certain Small Business Corporations as to Taxable Status." Subchapter R of Chapter I of Subtitle A, which contains only § 1361, is entitled "Election of Certain Partnerships and Proprietorships as to Taxable Status."

<sup>6</sup> Section 701 provides that partnerships are not subject to tax. Partners, like sole proprietors, are taxed as individuals under § 1.

<sup>7</sup> S. REP. NO. 1983, 85th Cong., 2d Sess. (1958) in 18 U.S. CODE CONG. & AD. NEWS at 6884 (Oct. 20, 1958).

<sup>8</sup> New § 6037, which is like § 6031 in the partnership area, has also been added to the Code. It requires the filing of annual information returns by an electing corporation. Sections 1016 and 1504 have been amended in keeping with the new subchapter.

In this connection this note will attempt *first*, to explain in general fashion the workings of sections 1371-1377; *second*, to make observations and raise problems with regard to the effect of these sections on other areas of the Code; and *third*, to discuss some problems raised by the statute itself.

*The Mechanics and Effects of Sections 1371-1377*<sup>9</sup>

Section 1371 defines<sup>10</sup> the "small business corporation" as a domestic corporation which has but one class of stock and no more than ten shareholders, all of whom are individuals or estates and none of whom are non-resident aliens. In addition, parent corporations are for the most part precluded from the election by the requirement that the corporation not be a member of an "affiliated group."<sup>11</sup> Due to subsections 1372(e) (4) and (5), two additional conditions must be met by an electing corporation: first, no more than 80 per cent of its gross receipts may be derived from sources outside the United States, and second, no more than 20 per cent of its gross receipts may be derived from annuities, dividends, interest, rents, royalties and sales or exchanges of stock or securities. In the latter instance, only gains from the sale or exchange of stock or securities will be taken into account in arriving at gross receipts and the 20 per cent limitation. A significant aspect of the definition is the omission of any maximum limitation on the amount of invested capital or on the amount of gross receipts, gross income or taxable income, within which a corporation would have to fall to qualify as a "small business corporation."

Section 1372 provides that an electing corporation shall not be subject to tax at the corporate level.<sup>12</sup> Consequently the only tax falls at the shareholder level, and the fundamental characteristic of corporate taxation—the double tax<sup>13</sup>—is eliminated. This section also sets forth the means by which the election may be effected,<sup>14</sup> revoked<sup>15</sup> or terminated.<sup>16</sup>

The election for a given year must be made during the first month of the taxable year or during the month immediately preceding said

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<sup>9</sup> For a detailed discussion of the mechanics of Subchapter S, see S. REP. No. 1983, 85th Cong., 2d Sess. (1958) in 18 U.S. CODE CONG. & AD. NEWS at 7013-22 (Oct. 20, 1958).

<sup>10</sup> § 1371(a).

<sup>11</sup> The definition given in § 1504 is used here.

<sup>12</sup> § 1372(a).

<sup>13</sup> The first \$25,000 of corporate income is taxed at 30% under § 11(b) (1); a surtax of 22% is imposed on any excess over \$25,000 under § 11(c), thus making the total rate 52%. Then upon dividend distribution the shareholder, if he be an individual, is taxed under § 1.

<sup>14</sup> § 1372(c).

<sup>15</sup> § 1372(e) (2). Revocation is classified as a species of termination even though it is dependent upon the voluntary consent of all the shareholders.

<sup>16</sup> §§ 1372(e) (1), (3), (4) and (5).

first month.<sup>17</sup> If it is made on or before the first day of the taxable year, all who are shareholders on the *first* day must consent; while if it is made after the first day, the consent of all who are shareholders on *that* day is required.<sup>18</sup> The manner in which the election can be availed of has been prescribed by temporary administrative regulations.<sup>19</sup> Once made, it continues in force for future taxable years, unless it is revoked or terminated.<sup>20</sup>

Similar to the case of an election, a revocation<sup>21</sup> must be accomplished by the corporation with the unanimous consent of all who are shareholders on the day of revocation. Such an act will be effective for the taxable year only if made during its first month; if made after the first month, it will be effective for the following taxable year. Revocation is not available for the first taxable year.

Section 1372(e) lists four events in which the election will automatically cease. Termination will result from non-adherence to the requirements of a "small business corporation" set forth in section 1371(a),<sup>22</sup> the violation of the limitation pertaining to the source of income,<sup>23</sup> or the violation of the limitation pertaining to type of income.<sup>24</sup> Again, termination results when one, who becomes a shareholder during a year for which the election is effective<sup>25</sup> but subsequent to the election, fails to file a consent<sup>26</sup> with the District Director of Internal Revenue within 30 days, inclusive of the day on which he becomes a shareholder.<sup>27</sup> Therefore, inaction by any new shareholder within the prescribed time, even though he be desirous of the continuance of the election, will result in its demise.

Termination, unlike revocation, is effective for the taxable year during which the terminating event occurs, even if the event occurs on the last day of that year. Moreover, termination applies to the first taxable year. Both termination and revocation are effective for

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<sup>17</sup> § 1372(c) (1). When the corporation's taxable year begins after the first day of the month, the period in which an election may be made will begin on the first day of such taxable year and end on the corresponding day of the succeeding month, or on the last day of the succeeding month if there be no corresponding day. Rev. Rul. 58-516, 1958 INT. REV. BULL. No. 42, at 19. As to an election for a taxable year beginning after December 31, 1957, and on or before the date of enactment of subchapter S, see § 1372(c) (2).

<sup>18</sup> § 1372(a).

<sup>19</sup> T.D. 6317, 1958 INT. REV. BULL. No. 41, labelled 18.1-1 at 77.

<sup>20</sup> § 1372(d).

<sup>21</sup> § 1372(e) (2).

<sup>22</sup> § 1372(e) (3).

<sup>23</sup> § 1372(e) (4).

<sup>24</sup> § 1372(e) (5).

<sup>25</sup> T.D. 6317, 1958 INT. REV. BULL. No. 41, labelled 18.1-1(b) (3) at 78 provides: "If the election is made before the first day of the corporation's taxable year, the consents of persons who become shareholders after the date of election and on or before such first day shall be filed with the district director with whom the election was filed as soon as practicable after such first day."

<sup>26</sup> § 1372(e) (1).

<sup>27</sup> T.D. 6317, 1958 INT. REV. BULL. No. 41, labelled 18.1-1(c) at 78.

all succeeding taxable years, and an election by the corporation or any successor corporation may not be made again for five years, inclusive of the year of termination or revocation, unless the Secretary consents.<sup>28</sup>

Section 1373, which is the central provision of the subchapter, taxes all current income of the corporation, whether distributed or undistributed, to the shareholder. In this respect section 1373 is similar to section 702 of the Code partnership provisions.<sup>29</sup> Included in the gross income of each shareholder for *his* taxable year is his pro rata share of undistributed taxable income remaining in the corporation at the end of *its* taxable year.<sup>30</sup> Undistributed taxable income is, in general, the taxable income of the business for the present taxable year, computed without regard to the net operating loss deduction<sup>31</sup> and minus the amount of money "dividends"<sup>32</sup> actually distributed.<sup>33</sup> Therefore undistributed taxable income will not be reduced by any distribution of property dividends.<sup>34</sup> Any distributed amount which exceeds corporate taxable income under section 1373(d) will probably be considered a dividend out of current earnings and profits to the extent that amount exceeds such taxable income.<sup>35</sup> Any distributed amount which exceeds the earnings and profits<sup>36</sup> of the current taxable year will *apparently* be taxed as a dividend to the extent of earnings and profits accumulated in prior years,<sup>37</sup> and any excess

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<sup>28</sup> § 1372(f).

<sup>29</sup> Subchapter K of Chapter I of Subtitle A of the 1954 Code is entitled "Partners and Partnerships" and encompasses §§ 701-71.

<sup>30</sup> § 1373(b). Thus, if a corporation, which has two shareholders holding an equal number of shares, has taxable income and earnings and profits of \$40,000 at the end of a given year, of which \$20,000 has already been distributed, each shareholder will have \$10,000 of "undistributed taxable income" included in his gross income. If one of these two shareholders had a taxable year which ended shortly before the end of the corporation's taxable year, the \$10,000 would be included in his next taxable year, that is, the taxable year in which the corporation's taxable year ended.

<sup>31</sup> Section 172 is the net operating loss deduction section. The computation of taxable income is also made without regard to the special deductions allowed a corporation under §§ 241-47. However, the organizational expenditure deduction under § 248 is taken into account.

<sup>32</sup> These amounts are described as dividends by the statute, even though no dividends-received credit or exclusion is allowed. Hereafter such amounts will be referred to as "dividends." See § 1375(b).

<sup>33</sup> §§ 1373(c), (d).

<sup>34</sup> S. REP. No. 1983, 85th Cong., 2d Sess. (1958) in 18 U.S. CODE CONG. & AD. NEWS at 7015 (Oct. 20, 1958).

<sup>35</sup> § 316(a)(2). This difference between current taxable income and current earnings and profits represents income not taxable to the corporation (tax-free items) and certain non-deductible expenses incurred by the corporation. Query: Could a conduit theory be adopted here?

<sup>36</sup> See § 312 as to the usual composition of earnings and profits. This section must be read in conjunction with § 1377 as to earnings and profits under this subchapter.

<sup>37</sup> § 316(a)(1).

then remaining will constitute a return of capital, reducing the adjusted basis of the stock.<sup>38</sup>

Under section 1374 the corporate net operating loss for a given electing year, which amount is not allowed as a deduction in computing the taxable income of the corporation under section 1373(d)(1), is transferred to the shareholder level.<sup>39</sup> The deduction is characterized as one attributable to a trade or business of the shareholder<sup>40</sup> and can be used to offset his individual income from any source. Moreover, this deduction may now be carried back to offset the income of an additional prior year.<sup>41</sup>

A unique feature of this section is the ability of any shareholder, no matter how short his stay in the corporation, to share in the deduction without being on hand at the end of the corporation's taxable year. To accomplish this, a daily operating loss,<sup>42</sup> averaged over the taxable year, is provided by section 1374(c)(1). Each shareholder's portion of the deduction becomes his pro rata share of the daily net operating loss multiplied by the number of days during the corporation's taxable year on which he enjoyed shareholder status.<sup>43</sup> However, this amount cannot exceed the sum of the adjusted basis of his stock<sup>44</sup> and the adjusted basis of any corporate indebtedness owing to him.<sup>45</sup> Unlike section 704(d),<sup>46</sup> any excess is lost forever. To

<sup>38</sup> §§ 302(c)(2), (3).

<sup>39</sup> § 1374(a). The loss is computed the same as in § 172(c), but only the § 248 deduction allowed under § 241 is taken into account.

<sup>40</sup> § 1374(d)(1).

<sup>41</sup> The Small Business Tax Revision Act of 1958, Title II, in 18 U.S. CODE CONG. & AD. NEWS at 6644 (Oct. 20, 1958), has amended § 172(b)(1)(A) to extend the carryback provision from two to three years. The five year carryforward period of § 172(b)(1)(B) remains intact. Under § 1374(d)(2) there is no carryback of losses to taxable years beginning before January 1, 1958.

<sup>42</sup> The corporation's daily net operating loss is simply the net operating loss of the corporation divided by the number of days in its taxable year.

<sup>43</sup> Thus if *A* sold his interest to *B* after 200 days of the corporation's taxable year had elapsed, *A* would reap the benefit of his pro rata share of 200/365ths of the corporation's net operating loss, while *B* would only get his pro rata share of 165/365ths of that same loss.

<sup>44</sup> § 1374(c)(2)(A). If the shareholder still owns the stock at the close of the corporation's taxable year, its adjusted basis will be determined as of that time. However, the basis of stock disposed of during the electing year will be determined as of the day before such disposition. Adjustments for the taxable year made under § 1376, which increase the basis of a shareholder's stock by his share of undistributed taxable income and decrease it by his share of the corporation's net operating loss, are disregarded. Query: Are the reductions of basis made under § 301(c)(2) for amounts distributed under § 1375(d)(1) also disregarded?

<sup>45</sup> § 1374(c)(2)(B). Similar to the procedure in note 42 *supra*, the adjusted basis of any corporate indebtedness owing to a shareholder is determined as of the close of the taxable year, or as of the close of the last day during the electing year on which such shareholder held stock in the corporation. Section 1376 adjustments are disregarded here also.

<sup>46</sup> Under § 704(d) any excess of loss over basis will be allowed as a deduc-

prevent the shareholder from possibly receiving a double benefit from this deduction, section 172 has been amended<sup>47</sup> so that the net operating loss of a corporation<sup>48</sup> shall not include the net operating loss of any taxable year for which the election is in effect, more clearly, any year in which the shareholder directly receives the deduction.

Normally the character of corporate income, unlike that of a partnership, does not carry over to the shareholder. Section 1375 departs from this principle somewhat by including in the gross income of each shareholder, at capital gain rates,<sup>49</sup> his pro rata share of the excess of the corporation's net long-term capital gain over its net short-term capital loss for the electing year involved.<sup>50</sup> This excess is not permitted to surpass the taxable income<sup>51</sup> of the corporation as determined by section 1373(d).

The 4 per cent dividends received credit<sup>52</sup> and the 50-dollar exclusion for dividends received from a domestic corporation<sup>53</sup> are not available to the shareholder to the extent of the corporation's earnings and profits or its taxable income for the current electing year, whichever is less. Both distributed and undistributed amounts may fall within the purview of this provision.<sup>54</sup> The shareholder is also deprived of the dividends received credit for the purpose of computing retirement income under section 37.<sup>55</sup>

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tion at the end of the partnership year in which the excess is repaid to the partnership.

<sup>47</sup> § 172(h).

<sup>48</sup> § 172(a).

<sup>49</sup> Corporations are taxed under § 1201(a) at a 25% rate on the excess of net long-term capital gain over net short-term capital loss. Other taxpayers under § 1201(b) may deduct 50% of the excess as an alternative to the 25% rate.

<sup>50</sup> § 1375(a). Terms relating to capital gains and losses are defined in § 1212. Under the limitation of § 1375(a), shareholders in a corporation with \$40,000 taxable income and earnings and profits in an electing year, computed in which is a \$50,000 excess of net long-term capital gain, can only include \$40,000 in their gross incomes at capital gain rates. This \$40,000 would, of course, be pro-rated among the shareholders according to the extent of their stock ownership.

S. REP. NO. 1983, 85th Cong., 2d Sess. (1958) in 18 U.S. CODE CONG. & AD. NEWS at 7019 (Oct. 20, 1958) provides that the amount treated as capital gain under § 1375(a) will be allocated ratably among all *actual* distributions. This is to prevent the shareholder from including all the capital gain in one year when the taxable year of the corporation includes two taxable years of the shareholder, and distributions are made in both of those years.

<sup>51</sup> See note 55 *infra*.

<sup>52</sup> § 34. This credit is only allowed to individuals on amounts received from domestic corporations and included in gross income. In the case of a taxable year ending after Dec. 31, 1954, it cannot exceed 4% of the individual's taxable income.

<sup>53</sup> § 116.

<sup>54</sup> § 1375(b).

<sup>55</sup> As earnings and profits of the current year, for the purposes of § 1375(b), are deemed not to exceed taxable income of the corporation under § 1373(d), a distribution out of current earnings and profits in excess of current taxable income would receive the various dividend benefits. On the other hand, what

Section 1375(d)(1) permits an electing corporation, in years subsequent to the years of inclusion, to distribute to any shareholder his net share of the corporation's undistributed taxable income, or any part thereof. Such a distribution is not considered a dividend, and double taxation is thereby avoided. This net share is the excess of the sum of all amounts previously included in gross income under section 1373(b) for all years of the particular election over the sum of net operating loss deductions allowable under section 1374(b) and amounts distributed under section 1375(d)(1) during the same period.<sup>56</sup>

Section 1376, which functions in a manner similar to section 705 of the partnership provisions, increases the basis of each shareholder's stock by any amount included in his gross income under section 1373(b),<sup>57</sup> and decreases first the basis of his stock, and then the basis of any indebtedness of the corporation to him by any amount allowable to him as a net operating loss deduction under section 1374(b). In keeping with the limitation in section 1374(c)(2), any excess after reduction is not considered.<sup>58</sup> When the shareholder actually receives a portion of his previously taxed undistributed taxable income, the basis of his stock is decreased under section 301(c)(2) by such amount.<sup>59</sup> Any excess here is treated as capital gain.<sup>60</sup>

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would happen if current earnings and profits could ever be less than § 1373(d) taxable income? Following the literal wording of the statute, dividend benefits would also apply to the difference in the latter situation, whether distributed or included under § 1373(b). However, in the first instance the excess represents current income of the corporation which under no circumstances would be taxable to it, whether electing or non-electing. In the latter instance the excess represents current income of the corporation which would be taxable to it except for the election. The dividend credit in the latter situation thus seems irregular. In any case, differences in current taxable income and current earnings and profits will probably cause, at least mechanical and perhaps substantial, difficulties under § 1375(b) and other sections of the subchapter, *e.g.*, § 1375(a)(1).

<sup>56</sup> § 1375(d)(2). Thus if a corporation composed of two shareholders had \$40,000 of undistributed taxable income in its first electing year and \$10,000 of net operating loss in its second electing year, only \$15,000 could be distributed to each under § 1375(d)(1) in the third electing year. However, if \$5,000 had been distributed to each shareholder under § 1375(d)(1) during the second electing year, only \$10,000 could be so distributed during the third year.

<sup>57</sup> § 1376(a). Any amount, taxed but not distributed, appears to be a contribution to capital under § 118.

<sup>58</sup> § 1376(b).

<sup>59</sup> Sections 301(c)(2) and (c)(3) apply to amounts not considered as dividends, and distributions under § 1375(d)(1) are expressly not considered dividends. It should be noted that, unlike the partnership area where § 705 and § 733 apply, one must go to another area of the Code for a reduction of basis provision which applies to § 1375(d)(1) distributions. Section 1376, the subchapter S basis section, does not provide for a reduction of basis on the distribution of amounts already taxed to the shareholder.

<sup>60</sup> § 301(c)(3)(A).



Section 1377 prevents double taxation to the shareholders of undistributed taxable income included in gross income under section 1373(b) by reducing the accumulated earnings and profits of the electing corporation, as of the close of its taxable year, by such an amount.<sup>61</sup> Actual distributions of money "dividends" naturally reduce earnings and profits also.<sup>62</sup> On the other hand, the shareholders, who directly receive the corporation's net operating loss deduction for its taxable year under section 1374(b), are prevented from receiving a possible double benefit by a subsection which provides that both current and accumulated earnings and profits will not be affected by any item of gross income or any deduction taken into account in the computation of this net operating loss.<sup>63</sup> A dual benefit is also forestalled under section 1375(d)(1) by the non-reduction of earnings and profits on the subsequent distribution of any net share of undistributed taxable income; this income had already reduced earnings and profits under section 1377(a). Moreover, current earnings and profits are not to be reduced by any amount not allowable as a deduction in computing taxable income as provided in section 1373(d).<sup>64</sup>

Prior to this subchapter, shareholders in a small business corporation, who fell into an income bracket far below the corporate rate but were desirous of accumulating funds for the reasonable needs of the business, had to suffer the 52% corporate tax; now, however, funds can be accumulated at the lower rates of these individual shareholders. Moreover, prior to this subchapter, such amounts were subject to the attack of unreasonable accumulation and the imposition of the accumulated earnings tax.<sup>65</sup> Now, as corporate income is taxed to the shareholders under section 1373(b) and earnings and profits consequently reduced under section 1377(a), no accumulated earnings tax need be or can be imposed on such accumulations. The very purpose of this tax, which is imposed at the corporate level, is to prevent the avoidance of a tax at the shareholder level on amounts which should be distributed to the shareholders, but which instead are unreasonably accumulated by the corporation. Under this subchapter, there is a single tax at the shareholder level, and the need

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<sup>61</sup> § 1377(a).

<sup>62</sup> § 312(a)(1).

<sup>63</sup> § 1377(c).

<sup>64</sup> § 1377(b). Query: Does § 1377(b) prevent current earnings and profits from being reduced only by those deductions specifically disallowed under § 1373(d), or does it prevent reduction of current earnings and profits by deductions normally disallowed in computing taxable income as well as those specifically disallowed under § 1373(d)? For example, premiums paid by the corporation on a policy insuring the life of a shareholder, wherein the corporation is a beneficiary, would reduce earnings and profits under the former interpretation, but not under the latter. However, the premiums in no instance would reduce the corporation's taxable income. See § 264(a). The former construction would tend to reduce current earnings and profits below current taxable income.

<sup>65</sup> §§ 531-37.

for section 531 ceases. This tax will apparently still apply to current earnings and profits in excess of current section 1373(d) taxable income, but no problem should ordinarily arise.<sup>66</sup>

### *The Election and Other Code Areas*

#### A. Collapsible Corporations

What has been termed a collapsible corporation involves a situation wherein: first, the stockholders seek to be taxed only at capital gain rates upon the ordinary income generated by the corporation's productive activities, and second, the corporation attempts to insulate itself from any tax on this income by a distribution to the shareholders of the productive property or of the claims to income arising therefrom, prior to any realization at the corporate level.<sup>67</sup> Section 341<sup>68</sup> of the 1954 Code focuses squarely and exclusively on the first objective by providing that as to collapsible corporations, as defined in section 341(b), gain, from the sale or exchange of stock<sup>69</sup> or from a distribution in partial<sup>70</sup> or complete liquidation<sup>71</sup> or a distribution which falls under section 301(c)(3), will be considered as ordinary income to the extent that it would have been considered, but for section 341, as long-term capital gain.<sup>72</sup> Thus, under section 341, the inherent ordinary income in the suddenly appreciated stock or property generally cannot escape at capital gain rates. However, property will not be considered a "section 341 asset"<sup>73</sup> if it has been held for a period of three years or more.

This section worked so well in certain situations that what would ordinarily have been capital gain, even if the collapsible corporation device had not been espoused, wound up being treated as ordinary income.<sup>74</sup> To correct this overzealousness present in the statute, the Technical Amendments Act of 1958<sup>75</sup> amended the section to provide

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<sup>66</sup> The accumulated earnings credit under § 535(c)(2) has been raised from \$60,000 to \$100,000 by the Small Business Tax Revision Act of 1958, Title II, in 18 U.S. CODE CONG. & AD. NEWS at 6650 (Oct. 20, 1958).

<sup>67</sup> Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code*, 64 YALE L.J. 1, 65-66 (1954).

<sup>68</sup> For an excellent discussion of collapsible corporations and § 341, see Donaldson, *Collapsible Corporations*, 36 TAXES 777 (1958).

Section 751, which deals with the collapsible partnership problem, provides that on the sale or exchange of all or part of a partner's interest, ordinary income will be realized to the extent of gain attributable to unrealized receivables and substantially appreciated inventory of the partnership.

<sup>69</sup> See § 1221.

<sup>70</sup> § 331(a)(2).

<sup>71</sup> § 331(a)(1).

<sup>72</sup> § 341(a).

<sup>73</sup> § 341(b)(3).

<sup>74</sup> See S. REP. NO. 1983, 85th Cong., 2d Sess. (1958) in 18 U.S. CODE CONG. & AD. NEWS at 6828 (Oct. 20, 1958).

<sup>75</sup> 72 STAT. 1606 (1958).

four automatic but limited exceptions in the section 331,<sup>76</sup> section 333,<sup>77</sup> section 337<sup>78</sup> and sales or exchanges of stock areas.<sup>79</sup> The carefully detailed mechanics of the recent amendment<sup>80</sup> preclude shareholders,<sup>81</sup> whose stock in trade is the same type of property as that owned by the corporation, from taking advantage of the exceptions, which depend chiefly on the observance of a limitation on the unrealized appreciation of the ordinary income assets<sup>82</sup> of the corporation. Thus, under certain conditions, corporate assets which would give rise to capital gains if sold by the corporation but to ordinary income if sold *by the shareholder* are included within the ordinary income assets *of the corporation*, and the statutory limitation will be exceeded.

Under a literal application of sections 1373(b) and 1375(a) of subchapter S, a shareholder apparently need not worry about the ordinary income censure which section 341 places on sales of stock or on distributions of property. The corporation can simply sell the capital or section 1231 asset at a capital gain and the gain, retaining its favorable character, will pass to the shareholder. Moreover, even shareholders whose stock in trade is the same type of property as that owned by the corporation may take advantage of the election.

There is a great contrast between the strict attitude of section 341, even as amended, and the simple mechanics of the election. Regulation 1.341-2 provides that "the existence of a bona-fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may be formed or availed off with a view to the [censured] action described in section 341(b)." <sup>83</sup> This test appears more stringent than the usual tax avoidance test employed in the dividend area,<sup>84</sup> where the presence

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<sup>76</sup> Section 341(e)(2) excepts certain distributions in complete liquidation which are taxed at capital gain rates under § 331.

<sup>77</sup> Section 341(e)(3) excepts certain complete liquidations which qualify for non-recognition treatment under § 333. The mechanics of § 333 make it very favorable to the liquidation of a *closely-held* corporation, which has a small earned surplus and owns assets that have greatly appreciated in value.

<sup>78</sup> Section 341(e)(4) excepts certain corporate sales or exchanges of property which come under § 337.

<sup>79</sup> § 341(e)(1).

<sup>80</sup> See, e.g., § 341(e)(5)(A)(i)(iii); § 341(e)(5)(B).

<sup>81</sup> Certain § 1231 real or depreciable business properties in the hands of the corporation would turn out to be stock in trade or property held primarily for sale in the hands of the shareholder. S. REP. NO. 1983, 85th Cong., 2d Sess. (1958) in 18 U.S. CODE CONG. & AD. NEWS at 6830, 6942 (Oct. 20, 1958) avowedly expresses an intention to prevent "dealers" from coming under the new § 341 exceptions.

<sup>82</sup> Actually assets as defined in § 341(e)(5)(A).

<sup>83</sup> Treas. Reg. § 1.341-2(a)(2) (1955). Section 341 utilizes a subjective intent test, which has been partially limited by the recent automatic exceptions.

<sup>84</sup> Distributions as a result of reorganizations: *Bazley v. Commissioner*, 331 U.S. 737 (1947); *Gregory v. Helvering*, 293 U.S. 465 (1935); see present § 356(a)(2). Distributions on partial redemption of stock other than in liquidation: *Commissioner v. Snite*, 177 F.2d 819 (7th Cir. 1949); see present

of a valid business purpose goes a long way in preventing the taxation of various corporate distributions as dividends. However, on the opposite extreme from the section 341 test is the election under subchapter S, where the *sole* purpose of the election can be tax avoidance of collapsible corporation effects. It appears grossly illogical to amend section 341 in a manner which is designed to prevent not the working, but the overzealousness, of the statute, and then to provide an election which nullifies both the original Code provision and its amendment. The Commissioner will certainly be heard from in this area.

### B. Section 337

Section 337 made its entry into the Code in 1954 to end the "double versus single tax" disparity existing between the *Court Holding*<sup>85</sup> and the *Cumberland*<sup>86</sup> situations by the imposition of a single tax on the sale of a corporate business accomplished through a sale of its assets. Adherence to the mechanics of section 337 produces non-recognition of gain or loss to the corporation on the sale or exchange of property<sup>87</sup> subsequent to the adoption of a plan of liquidation, as long as all of the assets of the corporation, except assets retained to meet creditor claims, are distributed in complete liquidation within 12 months from the date of adoption of the plan.<sup>88</sup> The only tax imposed is at the shareholder level at capital gain rates upon the complete liquidation.<sup>89</sup> Now sections 1373(b) and 1375(a) make it possible to obtain a single tax on the sale or exchange of a capital or section 1231 asset without the necessity of a subsequent liquidation. In addition to the continuance of the corporation, a benefit will be realized as to all corporate assets not involved in the

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§ 302(b)(1). Distributions on redemption of stock in partial liquidation; *Imler v. Commissioner*, 11 T.C. 836 (1948); see present § 346(a)(2). Sections 302(b)(2) and 346(b) are automatic exceptions to dividend treatment.

Especially in the latter two areas, the opinions give much verbal service to a test based on a consideration of all facts and circumstances, but as a practical matter the presence of a valid business purpose appears to be a *sine qua non*. See *Commissioner v. Snite*, *supra* at 822-23.

<sup>85</sup> *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) held that a sale of property, which had first passed to the shareholders in liquidation and had then been conveyed by the shareholders to the purchaser, had actually been executed by the corporation. Therefore, in addition to the tax at the shareholder level on liquidation, a tax was imposed at the corporate level on the sale.

<sup>86</sup> *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950) involved a situation similar to that of the *Court Holding* case. However, the Court held that the sale had been made by the shareholders, and the only tax was imposed at that level upon liquidation. There was no tax on the sale by the shareholders, as the distributed property had received an increased basis under § 334(a).

<sup>87</sup> "Property" as defined in § 337(b).

<sup>88</sup> § 337(a).

<sup>89</sup> § 331(a)(1). Section 336 provides that generally no gain or loss will be recognized to the corporation on a liquidation.

sale. If section 337 were utilized, a tax would be imposed on the appreciation in value of the remaining assets upon liquidation; the election, however, allows these assets to repose unaffected in the hands of the corporation, awaiting future disposal.<sup>90</sup>

Section 337, unlike section 341, was enacted to grant relief to the taxpayer. The election, insofar as it makes possible that which could not be accomplished under section 337, may be looked upon as an extension of benefits already conferred. However, it should be remembered that while the beneficial purpose underlying section 337 remains, its strict mechanics are obviated for all who can take advantage of the election.

### C. Partnerships and Proprietorships Which Incorporate and Elect

(1) Partners and proprietors do not fall into the class of employees, because they are considered self-employed; therefore, the various types of employee benefit plans available to stockholder-employees of a corporation (with the benefit of corporate deductions) are not available to them.<sup>91</sup> Consequently they must purchase present and future security with smaller, post-tax dollars. In the past, any effort to incorporate, and thereby acquire the corporation as an employer, meant submission to a double tax. Now, due to the election, partners and proprietors can incorporate and become eligible for employee benefits paid for with pre-tax dollars, while the application of a single tax continues. Retirement funds, based on pension or profit-sharing plans qualifying under section 401,<sup>92</sup> medical expenses for the employee and his family,<sup>93</sup> health and accident insurance<sup>94</sup> and group life insurance<sup>95</sup> all come to the newly transformed owner

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<sup>90</sup> Moreover, although § 337 requires a plan prior to a sale, the election may take place after a sale and yet be effective as to that transaction; this would occur where a sale was made during the first month of a taxable year and the election was made later on during that same month.

<sup>91</sup> The Jenkins-Keogh Bill, H.R. 9, H.R. 10, 85th Cong., 1st Sess. (1957), which failed to pass, would have allowed self-employed individuals to set up their own retirement funds while getting a deduction therefor.

<sup>92</sup> A deduction is given to the corporate employer for contributions which it makes to the § 401 fund under § 404, and not under § 162 or § 212. Via § 501(A) the trust set up under § 401 is exempt from taxation.

<sup>93</sup> See §§ 106, 105 and 213(a).

<sup>94</sup> Under § 106 the corporate employee gets an exclusion for amounts contributed by his employer to accident or health plans.

<sup>95</sup> Certain insurance premiums paid by the corporation on policies which ultimately will benefit the employees are deductible under § 162. See the exception to this found in § 264(a)(1), and recent case law developments in that area in 32 ST. JOHN'S L. REV. 338 (1958). Group term insurance premiums, as opposed to group permanent life insurance premiums, which are paid by the employer, are not includible as compensation in the gross income of an employee under Rev. Rul. 54-165, 1954-1 CUM. BULL. 17.

at pre-tax costs via this election windfall.<sup>96</sup> Moreover, even a sole proprietor who requires no other employees to carry on his business can qualify as an employee under section 401 upon incorporation.'

This new "security income" opportunity afforded under the section 1372 election is in great contrast with the section 1361 election, for under the latter section a partner or proprietor of an electing business is expressly not considered an employee for purposes of section 401.<sup>98</sup> This is so even though almost all of the Code's corporate provisions are applied to the section 1361 business,<sup>99</sup> including a subjection to the accumulated earnings tax.<sup>100</sup> Under section 1361 a double tax applies, yet the electing partners and proprietors are specifically excluded from section 401 status. Under subchapter S a single tax applies, but former partners and proprietors, now accounted in shareholder garb, can take advantage of section 401. Though it is true that unincorporated businesses, to take advantage of section 1361, need only change their tax and not their organizational status while, in order to avail themselves of a new tax status under subchapter S, they must also change their organizational status, the difference in section 401 treatment under the two elections seems incongruous.

(2) Section 1375(c), which is similar to subsections 704(e) (2), (3),<sup>101</sup> follows the *Lucas v. Earl*<sup>102</sup> rule of taxing compensation for personal services to the person who earned it. It provides that both "dividends" actually distributed to, and section 1373(b) undistributed amounts included in gross income by, any shareholder may be allocated by the Secretary among such shareholders of the corporation who are also members of the aforesaid shareholder's "family," if

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<sup>96</sup> For an excellent discussion of the security and fringe benefits, including estate tax advantages, obtainable by an election under subchapter S, see IBP, *Tax Planning*, section 2 (October 8, 1958).

<sup>97</sup> See Rev. Rul. 55-81, 1955-1 CUM. BULL. 392.

<sup>98</sup> § 1361(d).

<sup>99</sup> § 1361(c).

<sup>100</sup> § 1361(h) (2).

<sup>101</sup> Section 704(e) deals with family partnerships in which capital is a material income-producing factor. Section 704(e)(2) provides that income flowing from partnership interests created by gift will be allocated according to the partnership agreement except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital; in these instances, a proper reallocation of income will be made. Section 704(e)(3) states that a purchase of an interest by one member of a "family" from another will be considered a gift from the seller for purposes of § 704; the fair market value of such purchased interest is considered donated capital. See S. REP. NO. 781, 82nd Cong., 1st Sess. (1951), in 2 U.S. CODE CONG. & AD. SERV. at 2010 (1951). *Commissioner v. Culbertson*, 337 U.S. 733 (1949) still controls in this family partnership area where capital is not a material income-producing factor.

<sup>102</sup> 281 U.S. 111 (1930). See also *Commissioner v. Tower*, 327 U.S. 280 (1946); *Lusthaus v. Commissioner*, 327 U.S. 293 (1946).

such an allocation is necessary to reflect the value of services performed by these other shareholders for the corporation.<sup>103</sup> A special earmark of this subsection is that it is the *only* provision in the entire subchapter which expressly refers to a provision of the subchapter on partnerships. The reference is to the definition of "family"<sup>104</sup> contained in section 704(e)(3), which is applied directly to the section 1375(c) situation.

(3) Capital gain or loss will be recognized on the sale or exchange of a partner's interest<sup>105</sup> except to the extent that section 751 will treat certain amounts as ordinary income. It has already been mentioned that the sale of stock will provide the former partner with capital gain treatment on the value of his entire share, while the election will subject him only to a single tax as long as he remains in the electing corporation. On the loss side of the ledger, partners who incorporate in order to elect may also get the benefit of new section 1244,<sup>106</sup> if the newly formed corporation can qualify under the "small business corporation" definition of section 1244(c)(2) as well as under that of section 1371(a). This section, under certain conditions, will provide the new shareholder with ordinary loss on the sale or exchange of his stock, where before he, as a partner on the sale of an interest, might only have gotten a capital loss with all its inherent limitations.<sup>107</sup> The transformation of a partner via subchapter S and section 1244 is complete. It is also important to remember that compliance with section 351, on the exchange of partnership property solely for the stock and securities of the new corporation, will insure non-recognition of gain or loss on the transaction.<sup>108</sup>

### *Some Problems Raised by the Statute Itself*

- (1) Subchapter S has no maximum monetary limitation.<sup>109</sup>

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<sup>103</sup> Treas. Reg. 1.704-1(e)(3)(i)(c) (1956) states that in determining what constitutes a reasonable compensation for services, all facts and circumstances of the particular business, including the greater managerial responsibilities of certain partners and the amounts ordinarily paid to non-partners for comparable services, shall be considered.

<sup>104</sup> "Family" under § 704(e), and thus under § 1375(c), includes only an individual's spouse, ancestors, and lineal descendants, and any trusts for the *primary* benefit of such persons.

<sup>105</sup> § 741.

<sup>106</sup> Section 1244 was added by the Small Business Tax Revision Act of 1958 in 18 U.S. CODE CONG. & AD. NEWS at 6644-47 (Oct. 20, 1958).

<sup>107</sup> § 1211(b).

<sup>108</sup> For tax differences between a corporation and a partnership as to contributions of property and withdrawals of property from the business by a shareholder or a partner respectively, see SURREY & WARREN, *FEDERAL INCOME TAXATION* 1225, 1227 (1955 ed.).

<sup>109</sup> Section 1244, on the other hand, has no minimal requirement in time within which the corporation may qualify under the 50% limitation on the amount of investment income includable in gross receipts. Thus only a non-

Therefore, the election may possibly be taken advantage of by large, closely-held operating corporations which have never made a public offering of stock. Limiting this, of course, is the consideration that too large a business income will force the shareholders into a high income bracket, where the dual level of corporate taxation, with its offer of control over the time of dividend distribution and therefore inclusion, is more desirable. Indeed, this is often the reason for a section 1361 election.<sup>110</sup> However, dependent upon the shareholders' extra-business income status in a given year, it appears that the election may be used by an economically large section 1371(a) "small business" on a rapid "in and out" one year basis.<sup>111</sup>

(2) Although section 1371(a) purports to completely define a "small business" corporation for purposes of the election, as a practical matter such corporation must also meet the qualifications of subsections 1372(e)(4), involving source of income, and (e)(5), involving type of income; for if the limitations therein prescribed are transgressed in any electing year, the election terminates.

The limitations of these subsections are based on the concept of gross receipts for an electing year, although the composition of that total differs in both. Section 1372(e)(4) gross receipts include total amounts received by the corporation on the sale or exchange of stock or securities, while section 1372(e)(5) gross receipts include only gains from such sales or exchanges. This statutory phrase, "gains," gives rise to a problem of construction. The wording could apparently be taken to mean net gain, which has first been reduced by losses, yet the very use of the plural form suggests that such an interpretation might be erroneous. A net computation could easily have been spelled out by the use of the singular "gain." However, if the net figure was intended, what occurs when such transactions give rise to a net loss in a given year? Apparently, following the policy that losses from sales or exchanges of capital assets by a corporation shall be allowed only to the extent of gains therefrom,<sup>112</sup> the net loss would not figure in the computation of the limitation for the year in which it arose. But a net capital loss can be carried over to the next five succeeding years, if necessary, to offset capital gains arising during that same period.<sup>113</sup> Apparently it would not carry over for purposes of computing the section 1372(e)(5) type of income limitations for these years. Many problems will only be solved by the Regulations.

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inal amount of gross receipts may be involved in the computation of the limitation. See Legislation, 33 ST. JOHN'S L. REV. 172, 174 (1958).

<sup>110</sup> See authorities cited in note 2 *supra*.

<sup>111</sup> This situation would occur where the individual shareholders sustained large extra-business losses in a given year, which would offset the large business income. An election effective for that year would be favorable to the shareholders.

<sup>112</sup> § 1211(a).

<sup>113</sup> § 1212.



This concept of gross receipts, employed in the computation of the 20 per cent limitation in section 1372(e)(5), appears to go against the grain of the legislative purpose, the benefiting of small businesses. For example, any large item of pure dividend or interest income can be devoured by the enormous adjusted basis of some handy section 1231 property, not greatly appreciated in value and not essential to the business, which is sold by the corporation only to avoid the limitation in a given year. If an electing corporation annually expects a large investment income, it may continually buy and then sell such aforementioned property for the sole purpose of continually avoiding the 20 per cent limitation. A more realistic computation based on gross income would put the pure dividend item and the gain from the sale of such business property on an equal footing; the adjusted basis of such property would not then be a mere irrelevancy, but instead would be used to arrive at the amount of gain realized. This gross income concept appears to be the backbone necessary to replace the cartilage of gross receipts under the personal holding income limitation of section 1372(e)(5). Indeed the specific Personal Holding Company provisions<sup>114</sup> of the Code use a concept of taxable income, which is even a step further from gross receipts.

The Personal Holding Company sections provide a remedy for inadvertent violations of the limitations contained therein, through the use of a deduction for deficiency dividends.<sup>115</sup> What will happen if the limitations of subsections 1372(e)(4) and (e)(5) are similarly violated without any presence of fraud or deliberation? Unlike section 547, the statute puts forth no remedy nor hint of leniency.

(3) Both termination and revocation destroy the election, yet the latter requires the formal consent of all the shareholders, while the former can easily be accomplished by a single adroit shareholder. Moreover the effect of termination is sudden, for it can take place at any time during the taxable year, including the first one of the election, and be effective for that year. Revocation, on the other hand, to be effective for a given taxable year excluding the first year—for which the election is irrevocable—must be made during the first month.

Termination may apparently be accomplished simply by transferring a fractional part of one share to as many persons, as tenants in common, as will be needed to reach a total of eleven shareholders, or by the transfer of a share to a corporation in which the electing shareholder holds the sole or a majority interest. If there are already ten shareholders in a corporation the realignment of one share to the name of the shareholder and his wife as joint tenants with rights of

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<sup>114</sup> §§ 541-47.

<sup>115</sup> Section 547 allows a deficiency dividend deduction, whereby a deficiency in personal holding company tax may be avoided by a subsequent dividend distribution to the shareholders. See SURREY & WARREN, *FEDERAL INCOME TAXATION* 1186 (1955 ed.).

survivorship will suffice; again, the transfer of one share to a close member of the family, who then refuses to consent to the election, works the same magic. The possible methods of termination are many and varied and easily available to every shareholder. This ability to terminate at any time and still maintain substantially the same interest will prove a potent bargaining weapon to the minority or dissenting shareholder, and a facile tool to the self-interested shareholder who suddenly finds the dual level of corporate taxation more suited to his income status. Moreover, all the shareholders united can play a waiting game, which they cannot do with the power of revocation, and instantly throw off an election when hindsight proves the experiment would be too costly. Termination under the statute, with its readily available, automatic and instantaneous relief, can only spell transiency in tax status and tax planning, both at the corporate and individual levels. This terminable-at-will basis, which can even be exercised in a rapid, one-shot "in and out" fashion,<sup>116</sup> must be eliminated, or else treatment under subchapter S will become a matter of mere caprice, utilized only for advantage and rescinded when greater advantages loom elsewhere.

Section 1361 points the way. An election under that section is irrevocable,<sup>117</sup> and this effect is a continuing one subject only to a termination which occurs when in any year the electing proprietor or partners own less than an 80 per cent interest in the business.<sup>118</sup> In determining whether or not a termination has actually taken place, constructive ownership rules are applied<sup>119</sup> on the realistic theory that an owner cannot be and not be at the same time. These rules, if applied to the problem of termination under subchapter S as they are applied only to that situation under section 1361, would not be destructive of the availability of the new election to family groups. In any case any step taken by the Regulations in the direction of the "one cannot have his cake and eat it too" attitude of section 1361(g) will be a welcome addition to subchapter S.

(4) The daily net operating loss of section 1374(c)(1) is an average figure capable of computation only at the end of the electing year. Thus, the existence of a net operating loss during the period

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<sup>116</sup> See note 111 *supra*.

<sup>117</sup> § 1361(e). Section 63 of the Technical Amendments Act of 1958 in 18 U.S. CODE CONG. & AD. NEWS at 6610-11 (Oct. 20, 1958), which does *not* amend the Internal Revenue Code of 1954, now has provided for a fixed period during which a § 1361 election may be revoked, and that the revocation be effective retroactively for all prior electing years. The period for revocation is limited to the time between the date of enactment of this section and the last day of the third month following the month of publication of final regulations under § 1361. See S. REP. No. 1983, 85th Cong., 2d Sess. (1958) in 18 U.S. CODE CONG. & AD. NEWS at 7011-12 (Oct. 20, 1958). Temporary Administrative Regulations have been issued under § 63, T.D. 6332, 1958 INT. REV. BULL. No. 47 at 35-39. Section 1361(e), however, remains unaltered.

<sup>118</sup> § 1361(f).

<sup>119</sup> § 1361(g).

of the electing year prior to a sale of stock will not aid the seller if such loss is no longer in existence at the close of the taxable year. The converse is also true. This provision is in contrast with section 706(c)(2)(A) and Regulation 1.706-1(c)(2)(ii), which provide that the partnership year shall close, with regard to a partner who sells his entire interest,<sup>120</sup> as of the day of sale, and that such partner shall include in the taxable income of his taxable year within which or with which membership in the partnership ends, his distributive share of all the items described in section 702(a) *as of that day*, unless an agreement to the contrary has been entered into by all the partners. Here the actual income and losses prior to sale are looked to, and year-end totals need not be considered unless an agreement so provides.

Section 1374(c)(1) has presumably adopted a unique daily loss figure, rather than the single year-end inclusion which section 1373(b) applies to undistributed income, in order to prevent a sale of stock to a higher income bracket taxpayer solely for purposes of offsetting his income by a large net operating loss.

(5) The character of corporate income carries over to the shareholder in the capital gains area under section 1375(a). However, unlike section 702 of the partnership provisions, this carryover represents the exception rather than the rule. Thus while an individual partner's distributive share of the partnership's charitable contributions<sup>121</sup> is included in the computation of the 20 per cent of adjusted gross income limitation imposed by section 170(b)(1)(B),<sup>122</sup> no similar inclusion exists under subchapter S. Even with the election, the corporation gets the benefit of a 5 per cent of its taxable income charitable contribution deduction under section 170(b)(2),<sup>123</sup> and the individual shareholder maintains his 20 per cent or 30 per cent of adjusted gross income deduction, as the case may be.

Another limitation avoided by incorporation is the 3 per cent of adjusted gross income allowed for medical expenses of the individual, his spouse and dependents under section 213(a).<sup>124</sup> The corporation gets a complete deduction for contributions made to accident or health plans which compensate its employees for personal injuries or

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<sup>120</sup> Under § 706(c)(2)(B), when a partner disposes of part of his interest, the partnership year does not close as to him, but the partner's distributive share of § 702(a) items included in his taxable income is determined by taking into account his varying interests in the partnership during the partnership taxable year.

<sup>121</sup> § 702(a)(4). See also § 703(a)(2)(D).

<sup>122</sup> An additional 10% of adjusted gross income is available as a deduction under § 170(b)(1)(A) for contributions made to certain churches, educational organizations or hospitals.

<sup>123</sup> Moreover, any excess of the amount contributed over such limitation enjoys a two year carryover under this same subsection.

<sup>124</sup> Section 213(b) provides a second limitation with respect to medicine and drugs, and § 213(c) prescribes certain maximum limitations.

sickness, and under section 105(b), amounts expended for the medical care of the employee, his spouse and dependents are not includible in the employee's gross income. Section 213(a), however, specifically denies a deduction for medical expenses compensated for by insurance or otherwise. The former partner or proprietor and his family get the full benefit of corporate accident or health insurance, and the limitation which applied to any medical expenses incurred in his former status is now avoided as the corporation receives a complete deduction.<sup>125</sup> Moreover, single level taxation still remains.

(6) Under section 105(d), an injured or sick stockholder-employee who is thereby forced to absent himself from work may exclude from gross income up to \$100 a week in wage continuation payments. The corporation also gets a deduction for these amounts. If the electing corporation in a given year has a net operating loss as a result of section 105(d) payments, a dual tax benefit will accrue to the recipient stockholder-employee: he gets an exclusion under section 105(d), and under section 1374(b) he also gets a share of the corporation's net operating loss deduction attributable to the very payments made to him. For example, if a corporation with a single stockholder-employee had no taxable income in a given year and yet paid \$5,200 in wage continuation payments to this sole stockholder, it would have a net operating loss of \$5,200 which would go over to him as a deduction under section 1374(b), and could be used to offset his income from any source whatever. In actuality, the stockholder-employee is again receiving \$5,200 tax-free. This double benefit naturally is subject to diminution where the stockholder's share of the net operating loss is less than the amount of wage continuation payments excluded by him; it does not come into play at all when no net operating loss exists. This section 105(d)—section 1374(b) situation appears to be another election headache for the Commissioner. Moreover, a similar situation could arise as to amounts paid to a stockholder-employee under corporate accident or health insurance plans.<sup>126</sup>

(7) Section 1375(d)(1) provides that an *electing* small business corporation may distribute to each shareholder his net share of undistributed taxable income; this amount will not be considered as a dividend. Since an *electing* corporation is essential for the utilization of this subsection, what will become of distributions, previously taxed during an electing year as undistributed taxable income, made during a year in which a termination occurs or is effective, whether these distributions are made before or after the terminating event? Under 1372(e) termination is effective to obliterate the election for the year

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<sup>125</sup> Compare § 703(a)(2)(F). As to the corporate employee see §§ 106 and 105(b).

<sup>126</sup> See §§ 105(b), (e).

in which the terminating event occurs and the four succeeding taxable years.

Since these distributions are now made by a non-electing corporation, what are the tax consequences? When these distributed amounts were previously included in the gross income of the shareholder under section 1373(b), the basis of his stock was thereby increased under section 1376(a). The effect was the same as if the undistributed taxable income had in fact been distributed and then reinvested by the shareholder.<sup>127</sup> A distribution of these amounts in a non-electing year in which the corporation has earnings and profits would, unlike the section 1375(d)(1) situation, result in dividend treatment, following the principles of section 316(a). Apparently, provided the corporation first had distributed all its earnings and profits, both current and accumulated, in the non-electing year, a distribution of these previously taxed amounts would then constitute a return of capital reducing the basis of the shareholders' stock under section 301(c)(2).

(8) Section 706 goes to great lengths to insure that the taxable year of the partnership and the partners will in almost all instances be the same. However, no corresponding provision is found in subchapter S. Therefore, if a business incorporates so as to avail itself of a February 1—January 31 taxable year, while the shareholders are on the calendar year, an initial 23 month period during which the shareholders pay no taxes on corporate income included in their individual gross incomes will result. Moreover, an 11 month period will continue to operate in the taxpayers' favor. The reason for the omission in subchapter S of a provision similar to section 706 is not apparent.

#### *Some Conclusions*

(1) The expressed purpose of the election, making the choice of business organization independent of tax motives, will not be accomplished by the mechanics of sections 1371-1377. In fact the opposite is likely to occur, for instead of small closely-held corporations becoming the equivalent of small partnerships and proprietorships from a tax standpoint, the latter will incorporate and elect subchapter S<sup>128</sup> for the substantial security and fringe benefits now available to them with pre-tax dollars and without the cost of submission to double taxation. As mentioned previously, certain large operating corporations might also find an election practicable for limited periods; more-

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<sup>127</sup> S. REP. NO. 1983, 85th Cong., 2d Sess. in 18 U.S. CODE CONG. & AD. NEWS at 7021 (Oct. 20, 1958).

<sup>128</sup> This note has attempted to approach the problem of an election only from a viewpoint of tax considerations; there are naturally other business considerations, some of them peculiar to a particular business, which must be taken into account.

over, while parent-subsidiary corporations cannot avail themselves of the election due to the "affiliated group" qualification of section 1371(a), brother-sister corporations, which have the same or substantially the same shareholders, may qualify.

Subchapter S, regardless of its defects, is surely a landmark provision in the Code. A business which elects thereunder provides its owners with a single tax, some of it at capital gain rates, at the shareholder level; undistributed, as well as distributed, income is taxed to the shareholder and may be distributed subsequently; the accumulated earnings tax does not apply to such amounts, but they are subject to reallocation among the gross incomes of the other shareholders to allow for reasonable compensation of services rendered to the business. All of the foregoing are attributes of a partnership, yet many corporate attributes still remain, as the deductions which the business receives for contributions to funds and plans which will benefit its "owner"-employees, the entire capital gain treatment and possibly some ordinary loss treatment on the sale of stock interests, and the ability to deduct certain amounts as charitable contributions while leaving inviolate the charitable contribution deductions of the individual business owners. The election under section 1372, rather than eliminating a tax choice between the corporation and the partnership or sole proprietorship, has simply added a third alternative. What business form shall it be: corporation, partnership or the intermediate tax entity, a corporation qualifying for an election under subchapter S?

(2) Many problems are left to the Regulations;<sup>129</sup> some expressly so by statute, as in section 1372(e)(1)(B). Regulations are normally issued for the purpose of clarifying the statute; however, those under sections 1371-1377 will undoubtedly contain much in the way of administrative legislation, especially as to voids left by the statute itself.<sup>130</sup> The effect of this subchapter on other areas of the Code, such as the collapsible corporation area, will most likely have to await judicial decision.

Will motive and business purpose tests be applied to some of these elections which seek to avoid the consequences of other Code sections, which represent a strict income tax policy? If such tests are used, how can they be applied to some elections and not to others without causing a great deal of doubt in tax planning? Yet if these tests are applied to all elections, the desired facility of the statute would be defeated; if they are applied to none, tremendous loopholes in the Code will be opened. Moreover, there is a considerable difference between applying external administrative and judicial tests

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<sup>129</sup> As yet no formal Regulations have ever been issued concerning the complementary election under § 1361. But see note 117 *supra*.

<sup>130</sup> The subchapter, for all its importance, is almost destitute of cross-references. No reference at all is made to the momentous § 401 area, while § 1361 devotes a specific statutory subsection to the same area.

to the mechanics of a few individual Code sections, such as sections 346(a)(2) and 356(a)(2), and applying these same tests to an entirely new subchapter which deals with the complete tax treatment of a particular business entity.

The safest attitude for business entities seeking a forbidden loophole in the Code is to await with Laputan gaze further glosses on the election. Action here should only be taken when absolutely necessary, that is, when tax defeat is imminent on other Code frontiers. The average small businessman and store owner should elect. He can gain limited liability, and even though his individual note or indorsement may still be required in contract transactions, protection in the area of torts will be afforded. Also he will remain subject to a single tax and reap newly available present and future security benefits at less expense. Neither need there be worry about the Commissioner, for the small businessman is the taxpayer for whom the election was actually intended.

(3) A state of present clarity and not a prospect of future confusion would now exist if the partnership provisions had been incorporated by reference in a single election definition section similar to section 1371(a). Why this was not done is not now apparent.

In writing of just such an election in 1955, Surrey and Warren stated: "It would seem the part of discretion at the very least to see if the new partnership provisions work properly when applied to partnerships before attempting to ascertain if they can be applied to corporations."<sup>181</sup> What will be said of the intermediate entity now provided by subchapter S?

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<sup>181</sup> SURREY & WARREN, *FEDERAL INCOME TAXATION* 1237 (1955 ed.).